

THE HORROR-SCOPE FOR THE TAXATION OFFICE: THE INTERNET AND ITS IMPACT ON 'RESIDENCE'

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I. INTRODUCTION

The Internet is said to facilitate tax planning and tax avoidance in the income tax context.¹ This assertion is broadly based upon the assumption that:

[g]lobal computer-based communications cut across territorial borders, creating a new realm of human activity and undermining the feasibility – and legitimacy – of laws based on geographic boundaries.²

But is this indeed a well founded forecast or merely a panic ridden, attention seeking horror-scope? This paper revisits the 'residence' tests in light of the communication revolution. It examines the extent to which Australian individuals and businesses can use the Internet to reduce their income tax liability without evading it, that is without criminal falsification or non-disclosure. It considers the Internet's peculiar potential for legitimate tax planning, that is the exploitation of legislated tax incentives and ordinary business structure to obtain a favourable tax result, and for tax avoidance, which is the minimisation of taxation through legal means which are artificial and have no point other than getting a tax benefit.

A taxpayer, whether an individual or a company, who is a resident of Australia is taxable on ordinary and statutory income derived directly and indirectly from all sources whether in or out of Australia.³ The general rule for non-residents is that

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1 See for example: Computer Money Consulting Pty Ltd, *INET 97/2 Report: Electronic Commerce, Banking and Finance Issues*, June 1997, at <<http://www.ato.gov.au/ecp/conrep.htm>>; Australian Tax Office, *Tax and the Internet*, Discussion Report of the ATO Electronic Commerce Project, August 1997, at <<http://www.ato.gov.au/ecp/ecp.htm>> at 97-100.

2 DR Johnson and D Post, "Law and Borders: The Rise of Law in Cyberspace" (1996) 48 *Stanford Law Review* 1367 at 1367.

3 Sections 6-5 and 6-10 of the *Income Tax Assessment Act 1997* (Cth) (ITAA 1997).

they are liable to Australian tax on all items of ordinary or statutory income which have their source in Australia.⁴ Thus the criteria on which income tax liability in Australia is based are firstly, Australian residency and, secondly, Australian source.

The concept of residence and the Internet seem to be inherently connected. The international and borderless nature of the Internet entails a paradoxical situation in regards to residence. On the one hand the Internet has made the world a smaller place; it has vastly reduced the distance between people everywhere. Geographic location and thus residence are reduced to an irrelevance. No matter where you are, with a modem you are never far away. This also stimulates more global collaborative activities and multinational ventures and international trade.⁵ On the other hand geographic location and residence are likely to assume a new peak of importance in the real world, particularly to businesses. The heightened competition in an international marketplace will force businesses to seek the most favourable place of residence. And the Internet provides the information and opportunities necessary to make residence more a matter of deliberate choice rather than fate. This paper explores how the taxation rules on residence will cope with the Internet's irreverence for geographic location and its simultaneous push for greater mobility.

While this paper examines 'residence' within the tax context, the same or similar questions arise in other areas of law which rely on a residence concept. For example, the issue of which law governs the affairs of a multinational company, such as its existence, capacity, internal structure and external legal relations, is often determined by inquiring where the company is resident. Although a determination of residence in the revenue context will often be based on different considerations than those, for example, in the consumer protection or minority shareholder contexts, the treatment of residence for tax purposes may nevertheless prove valuable for those areas of private international law.

II. RESIDENCE OF INDIVIDUALS

Section 995-1 ITAA 1997 defines 'Australian resident' as a person who is a resident of Australia for the purposes of the Income Tax Assessment Act 1936 (Cth) (hereafter ITAA 1936). Section 6(1) of that Act defines a resident of Australia in regard to individuals as:

a person... *who resides in Australia* and includes a person -

whose domicile is in Australia, unless the Commissioner is satisfied that his permanent place of abode is outside Australia; or

who has actually been in Australia, continuously or intermittently, during more than one-half of the year of income, unless the Commissioner is satisfied

⁴ Sections 6-5(3) and 6-10(5) ITAA 1997.

⁵ US Department of the Treasury, Office of Tax Policy, *Selected Tax Policy Implications of Global Electronic Commerce*, November 1996: <<http://www.fedworld.gov/pub/tel/internet.txt>> para 7.5.

that his usual place of abode is outside Australia and that he does not intend to take up residence in Australia; or...'⁶ (emphasis added).

It has been argued that in particular the '183 days' test in paragraph (ii) is increasingly archaic in the Internet age. The argument runs as follows:

[I]n the context of the Internet, the 183 days test becomes even more untenable. The geographic location of a person has historically been important ... [but] ... becomes almost meaningless when technology exists that enables an individual to carry out almost every facet of life in another jurisdiction while never actually physically leaving their geographic location even for a single day. A person could effectively make thousands of trips per year via the information superhighway to another jurisdiction without ever being subject to a border control mechanism.

To deal with this apparent problem another commentator recommended that:

[c]onsideration [should] be given to changing the definition of individual residence to ensure that previous permanent residents remain residents for a period, say two years, after leaving Australia. Alternatively some thought may need to be given to the approach taken in the United States, that is to reserve the right to tax citizens. This means that Australians operating from locations offshore might still be liable for Australian tax even though they have escaped being classified as a resident.⁸

The problem envisaged is that individual taxpayers will flee high-income tax jurisdictions such as Australia and set up camp in traditional tax havens. There they would carry on via the Internet exactly the same business they formerly conducted, with the slight difference of escaping the tax liability they would have had as an Australian resident. In fact, it is suggested, individuals can avoid being treated as a resident of *any* country by living on a yacht on the high seas.⁹ What these visionaries do not seem to understand is that most people would rather pay their tax than be permanently seasick. Of course, there will always be some individuals prepared to make sacrifices in order to exploit the remote control opportunities offered by the Internet to reduce their tax liability. What is the minimum these individuals would have to do to qualify as non-residents? Are the 'resident' tests more prone to manipulation in the digital age?

The primary test of residence, which is a question of fact and degree,¹⁰ is whether or not the taxpayer 'resides' in Australia, according to its ordinary meaning which is to 'have one's home, dwell permanently.'¹¹ Factors taken into account to determine residency according to this primary test are the taxpayer's actual presence, the maintaining of a home, the presence of immediate family members, employment, and business and social relationships.¹² This primary test is enlarged by the statutory tests, in particular the 'domicile and permanent place

6 The third test which is not considered in this paper provides that person is a resident if he or she is (A) a member of the superannuation scheme established by deed under the *Superannuation Act 1990* (Cth); or (B) an eligible employee for the purpose of the *Superannuation Act 1976* (Cth); or (C) the spouse, or a child under 16, of a person covered by the sub-subparagraph (A) or (B).

7 Z Muscovitch, "Taxation of Internet Commerce", Paper Archive #1 at

<<http://www.2.magma.com/~dbell/>>; cited in Computer Money Consulting Pty Ltd, note 1 *supra* at 47.

8 Computer Money Consulting Pty Ltd, note 1 *supra* at 47.

9 *Ibid.*

10 *Commissioner of Taxation v Miller* (1946) 73 CLR 93.

11 *The Australian Concise Oxford Dictionary* (1st ed, 1987) p 941.

12 For a non-authoritative summary of the case law on the meaning of "reside" see TR 98/D1 at <<http://www.ato.gov.au/>>.

of abode' test and the '183 day' test. The effect of these two statutory tests is that even taxpayers who would not be considered Australian residents in the ordinary sense of the word are resident taxpayers anyway.

Under the statutory 'domicile' test,¹³ an individual may be a resident for taxation purposes despite having lived outside Australia for a significant time if his or her 'domicile' is in Australia. Domicile comprises the elements of residence and of an intention to remain either permanently or indefinitely in the place of residence.¹⁴ The only way to qualify as a non-resident (for the time of the actual overseas stay) in these circumstances is if the Commissioner is satisfied 'that his permanent place of abode is outside Australia'. Although 'permanent' falls short of 'everlasting', what is important is that the taxpayer has left Australia for an indefinite period¹⁵ and has abandoned any residence or place of abode he may have had in Australia.¹⁶ Some of the factors taken into account to determine whether the taxpayer has a permanent place of abode overseas are the actual and intended length and continuity of the taxpayer's stay overseas and whether he or she has established a home overseas and the durability of association she or he has with Australia.¹⁷ This test seems to present a significant hurdle to those Australian individuals who are even prepared to spend a significant amount of time overseas to reduce their tax liability, but are ultimately not prepared to absent themselves indefinitely.

While the 'domicile test' requires nothing short of cutting most (if not all) ties with Australia to acquire the status of non-resident, what about the '183 day' test? Section 6(1)(a) deals with the acquisition of residence and not with the acquisition of non-residence.¹⁸ The purpose of the statutory tests is to increase the number of residents. Thus the '183 day' test applies to those who are *prima facie* non-residents but spend some time in Australia and are not yet caught by the preceding residents tests. It is aimed at people from overseas who stay in Australia for longer periods such as overseas students and visitors on a working holiday. The '183 day' is of no use to Australians who want to alter their residence status in the foreseeable future to make the most of the Internet. Last but not least, there is the option of dual residency. If a taxpayer is resident in more than one place¹⁹ he or

13 This test is considered in detail in IT 2650 at <<http://www.ato.gov.au/>>. This Income Tax Ruling "provides guidelines for determining whether individuals who leave Australia temporarily to live overseas... cease to be Australian residents for income tax purposes during their overseas stay."

14 *Applegate v FCT* (1979) 9 ATR 899. The first domicile is acquired at birth either from the father's or mother's domicile. To acquire a new domicile it is necessary both to move to a new place and to intend to remain there permanently. Once a domicile is established it remains the domicile even during absence as long as there is the intention to ultimately return to that domicile as a permanent residence. Unlike with residence a person can only have one domicile.

15 *Applegate, ibid.* See also: *Case 18* Vol 27 (1983) CTBR (NS); *Case 145* Vol 27 (1984) CTBR (NS).

16 *Applegate, ibid.*

17 Note 13 *supra*.

18 The New Zealand legislation expressly provides for the acquisition of non-residence: s OE1(3) of the *Income Tax Act* 1994 (NZ). See also WM Patterson and SR Lamb, "Residence of individuals and the Income Tax Amendment Act (No 5) 1988" (1990) 3 *New Zealand Law Journal* 102; A Alston, "The Concept of Residence in Taxation" (1990) 14 *New Zealand Law Review* 179.

19 *Lysaght v IRC* (1928) 13 TC 511, in which case the taxpayer was held to be resident both in the UK and in Ireland.

she may be relieved of the tax liability in one location by virtue of double tax treaties. These usually contain a 'tie breaker provision' which attempts to allocate residency to one of the two treaty countries. Yet, those countries with very favourable taxation are usually not parties to double tax agreements and thus are not available to a resident of both Australia and one of the traditional tax havens.

In summary, the minimum an Australian individual would have to do to avoid being treated as a resident of Australia for income tax purposes is to move indefinitely to a tax haven – a price likely too high for most.²⁰ The Internet cannot change that fact. The reason why the resident test for individuals is fairly immune against manipulation in the Internet age is that they it relies on a substantive rather than a formal nexus between the individual and the territory of Australia; it is not made dependent on formal criteria such as citizenship but on the real substantive ties the individual has with the jurisdiction. These substantive ties will remain important to most individuals. No matter how much the Internet reduces the importance of the geographic location of the person behind an on-line business, geographic location is and will remain crucial to people in the social context, at least in the foreseeable future, even with the most excellent communication channels at their fingertips.²¹

What about those individuals who are prepared to live in tax havens or even on the high seas in order to gain the tax advantage by conducting their business remotely via the Internet? Let them. After all, taxes are the price we pay for civilised society,²² for living in Australia. To deal with them by extending the definition of resident to include Australian citizens is misplaced. Income tax liability is based upon the nexus between the taxpayer (or the source of income) and the taxing jurisdiction. The nexus of residence should, and does currently, reflect both the equitable notion that those who pay taxes will directly or indirectly benefit from them and the practical reality that it is difficult to enforce a tax imposed on an individual who is outside Australia. Citizenship only marginally reflects these underlying justifications. Although most Australian citizens live in Australia, you can be an Australian citizen and never set foot in the country. And Australian citizenship per se does not entitle anyone to health care benefits, social security, pensions etc,²³ the stuff taxes are paid for and to all of which 'non-citizens' may be entitled. Other benefits which are paid for by revenue such as roads and community services can clearly only be enjoyed by persons actually present in Australia.

20 "[E]migration to another country is unlikely to take place unless it offers a better environment or at least one equivalent to that left behind." OECD, *Issues in International Taxation No 1; International Tax Avoidance and Evasion; Four Related Studies*, 1987 at 25.

21 One of the latest developments is 'The Meeting Machine', which allows video-conferencing via a palmtop which uses a miniature built-in camera for sending wireless video and still images. "Living IT", *The Weekend Australian*, 1-2 August 1998, p 2.

22 Associate Justice Oliver Wendell Holmes, quoted in Internal Revenue Service, *Criminal Investigation, FY 1997, National Operations' Annual Report*, available at <<http://www.treas.gov/irs/ci/programbook/.htm>>.

23 For example, entitlement to receive Medicare benefits is conferred on Australian residents, defined as persons who, first and foremost, reside in Australia: *Health Insurance Act 1973* (Cth), ss 3(1), 10, and 21. Temporary residents and persons merely visiting Australia, whether Australian citizens or not, would not normally be Australian residents and would not be eligible for benefits: IT 2615, at <<http://www.ato.gov.au/>> at para 12.

The one justification for taxing citizens who leave Australia may be that they should be made to pay for their right to vote,²⁴ which entails the right to influence how taxes are allocated and how revenue raised is spent, and the right to return to Australia at any time. This may be the rationale for countries such as Canada, Denmark, Sweden, the United States and Germany for making taxpayers leaving the country on a permanent basis, subject to taxation in their country of origin for a prescribed period after they leave.²⁵ The German Foreign Tax Law,²⁶ for example, applies to German citizens or former German citizens who transfer their residence from Germany to a low-tax country²⁷ and, who for five out of the last ten years, were German citizens or subject to German tax as residents. Such an individual is subject to German income tax for ten years after the year of emigration on all income that would not be considered as foreign source income for the purpose of the foreign tax credit provision, but only if he or she *retains a significant economic interest*²⁸ in Germany after transferring residence. These provisions are insightful for a couple of reasons. First, the requirement that the person must retain a significant economic interest in Germany reflects the all-important consideration of practical jurisdiction. Secondly, in the Australian context, a 'significant economic interest' might be evidence that the person has not abandoned any residence or place of abode he may have had in Australia²⁹ and thus points in favour of residency under existing Australian law.

Overall, the residence test for individuals is not threatened by the development of the Internet despite the fact that it is a legal concept 'based on geographic boundaries.'³⁰ The reason for its robustness, namely its reliance on the real ties people have with the territory, may be helpful when remodelling other legal concepts which are severely challenged by the communication revolution, which brings us to the residence test for companies.

III. RESIDENCE OF COMPANIES

Section 6(1) ITAA 1936 defines a company which is resident in Australia as

a company which is incorporated in Australia, or which, not being incorporated in Australia, carries on business in Australia, and has either its central management and control in Australia, or its voting power controlled by shareholders who are residents of Australia.

In other words a company is a resident of Australia

- if it is incorporated in Australia; or

24 *Commonwealth Electoral Act 1918* (Cth), s 93.

25 OECD, *International Tax Avoidance and Evasion*, Four Related Studies, Issue in International Taxation No 1, 1987 at 24.

26 Section 2 of the German Foreign Tax Law (Gesetz ueber die Besteuerung bei Auslandsbeziehungen, AStG), at <http://www.refact.de/cgi-bin/rda_inh2.cmd>.

27 Defined as a country imposing less than two-thirds of the tax imposed in Germany. *Ibid*, s 2(2).

28 *Ibid*, s 2(3).

29 See text accompanying note 16 *supra*.

30 See text accompanying note 2 *supra*.

- if it carries on business in Australia and is centrally managed and controlled in Australia; or
- if it carries on business in Australia and its voting power is controlled by shareholders resident in Australia.

The question is whether these tests are as immune to manipulation in the Internet age as the resident tests for individuals. Or can Australian businesses use the Internet to reduce their tax liability by shifting a company's residence with minimal inconvenience? Each test will be considered separately below.

A. Incorporation

The first test of residence for companies is that of place of incorporation.³¹ It overrules the traditional common law position according to which incorporation in a particular country was not decisive in determining whether a company was resident there.³² Although at first it appears that residency is equated with place of incorporation, this holds true only for companies incorporated in Australia. Importantly, the effect of the two following tests of residence is that companies incorporated outside Australia may nevertheless be Australian residents for tax purposes.

The incorporation test will prove to be a double-edged sword in the digital age. Its beauty lies in its great certainty and ease of administration when other concepts bend under the weight of the Internet challenge. The US Department of Treasury puts it as follows:

The growth of new communications technologies and electronic commerce will likely require that principles of residence-based taxation assume even greater importance. In the world of cyberspace, it is often difficult, if not impossible, to apply traditional source concepts to link an item of income with a specific geographic location... By contrast, almost all taxpayers are resident somewhere. An individual is almost always a citizen or resident of a given country and at least under US law, all corporations must be established under the laws of a given jurisdiction.³³

On the other hand, the Internet provides the tool to incorporate a business anywhere with great ease and thus abuse the incorporation test. The problem of 'pseudo-foreign' corporations is of course not new. The equivalent of 'flags of convenience' for ships is commonly known in the corporation context as the Delaware syndrome, named after the state most favoured in the United States for the incorporation of companies because of its lax corporations law.³⁴ This has been a problem particularly for those jurisdictions which rely heavily on the place of incorporation to link a company to a particular jurisdiction.³⁵ The Internet promises to provide the information and tools necessary to incorporate a business

31 For the equivalent test in the UK see the Finance Act 1988, s 66(1).

32 *Todd v Egyptian Delta Land Investment Co Ltd* (1929) 14 TC 119.

33 US Department of the Treasury, Office of Tax Policy, *Selected Tax Policy Implications of Global Electronic Commerce*, November 1996, at <<http://www.fedworld.gov/pub/tel/internet.txt>> para 7.1.5.

34 RR Drury, "The Regulation and Recognition of Foreign Corporations: Responses to the 'Delaware Syndrome'" (1998) 57 *Cambridge Law Journal* 165 at 167.

35 *Ibid.*

offshore with minimal effort and thus make the option more attractive to businesses. Although still far from being developed to its full potential, incorporation overseas, including the traditional tax haven, has already been made much easier by the Internet. An example is the Eurobank in the Cayman Islands at <<http://www.eurobank.ky/banks.html>>. Its brochure, which can be ordered over its website, states:

For arranging the incorporation of Cayman Islands Ordinary (Non-Resident) or Exempt Company with an Authorised Share Capital of US\$50 000 or less including stamp duty, provision of company seal and minute book: Ordinary Non-Resident Company US\$ 1,600; Exempted Companies US\$ 1 700.

Thus, the Internet already gives easy access to the information and the professional services required to incorporate a company in a tax haven, and the costs are low, particularly in view of the potential benefits. These facilities are likely to substantially improve in the future, as foreshadowed in a website called 'Anguilla As An Offshore Financial Center' which states:

The formation of companies by overseas registered company formation agents is provided for. An offshore company formation agent in Hong Kong and New York, once registered with the Anguillian Registry of Companies, may incorporate companies, IBCs [International Business Company], LLCs [Limited Liability Companies] etc, through a modem, directly with the Anguilla Registry of Companies... A Certificate of Registration is generated by the Registry computer in Anguilla, and is transmitted instantaneously from the Registry computer to the incorporator's computer, making Anguilla the most technologically advanced company formation jurisdiction in the world.³⁶

It seems only be a matter of time before on-line registration anywhere in the world is commonplace.³⁷ And the decision to incorporate a business offshore may not necessarily be based on tax considerations, but also, for example, on the relative leniency of corporations law requirements.³⁸ If this occurs in a country with which Australia has entered into a double tax treaty which resolves the problem of dual residence by placing primacy on the place of the incorporation,³⁹ a business carried on in Australia will not be subject to the tax burden of an Australian resident.⁴⁰ Thus in the future the availability of relief from double taxation may need to be reviewed with regard to jurisdictions which happily suffer the Delaware syndrome.

The reason why the incorporation test of residence is highly vulnerable to manipulation in the Internet is its reliance on form. Its equivalent in the context of

36 At <<http://www.offshore.com.ai/mitchells/mitchaxa.html#intro>>. See also, Offshore Information Services Ltd, *Services Available from Offshore Information Services Ltd* at <<http://www.offshore.com.ai/>>, which offers "Virtual Website and Corporation, \$1 500 first year".

37 In Australia the Company Law Review Bill 1998 (Cth) will make changes to the Corporations Law enabling the increased use of communication technology in calling and holding company meetings, lodging proxy forms and lodging documents with the Australian Securities Commission.

38 Note 34 *supra*.

39 For example, Article 4(5) of the Agreement between Australia and the Philippines for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income; Article 4(4) of the Convention between Australia and Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income.

40 Depending on whether the business has a permanent establishment in Australia it may be liable to tax on income sourced in Australia.

individuals would seem to be citizenship. As citizenship does not necessarily entail substantial ties between the citizen and the state granting citizenship, neither does incorporation require a substantial connection between the company and the place of incorporation. Given the conclusion above on the weak justifications for taxing citizens, the question arises why the place of incorporation should assume so much more significance in the residence test of companies. The answer appears to lie in the simple fact that companies as separate legal entities are artificial persons.⁴¹ While individual taxpayers may be physically present in a country (whether their country of citizenship or not), companies as entities *separate from their shareholders and directors* have no body to speak of. The requirement to keep a registered office and a register of shareholders serves as a physical token of their existence at least in the place of incorporation. But, the visible 'bodies', and thus physical presence, companies had before the Internet outside their place of incorporation, for example in form of permanent establishments and subsidiaries, are rapidly dissolving in cyberspace. This is particularly applicable to companies offering services and products which can be delivered entirely on-line,⁴² or which have outsourced most or all of the 'physical aspects' of the business.⁴³ Also, to the extent to which a company is no more than an idea or concept, a creature of statute, it can only be 'resident', if at all, in the place which supports its continued existence, which is the place of its incorporation.⁴⁴ All this is entirely different for individuals vis-à-vis their country of citizenship and explains the greater role the place of incorporation plays in establishing residence. In this context, it should be noted that it remains to be seen whether consumers will generally accept the risks inherent in dealing with a business whose physical shopfront is either in a totally different part of the world or non-existent. It may be that, apart from very few businesses with well-known brand names, consumers will favour those vendors they can touch and see. This would generally help to geographically pinpoint companies outside their place of incorporation.

In summary, although the incorporation test promises to provide great certainty in an age when certainty becomes a rarity, the value of that certainty is dubious. Yet, while the substantial link companies have with their place of incorporation may decrease, many companies may soon display no more physical signs of belonging anywhere apart from that very place of incorporation. Some of the inadequacies of the incorporation test in the digital age may be remedied by the second test in s 6(1) ITAA1936.

41 If you take away the fact (and place) of incorporation you also at least partly remove the rationale for taxing them as separate entities.

42 Typical examples can be found within the industries of computer software, news, recorded music, gambling and travel.

43 "Examples of full or partial virtual companies abound, often in instances one would not suspect. Sportswear maker Nike uses subcontractors to manufacture all its footwear and apparel. Sarah Lee hopes to revive its clothing division through the sale of its textile factories, outsourcing manufacturing and concentrating on the management of its supply chain." *The Australian*, 16 June 1998, p 60.

44 This is not to say that a company can have no existence outside the jurisdiction in which it was incorporated, a view which was prevalent in the last century and which has since been refuted. Note 34 *supra* at 176.

B. Central Management and Control

The test of central management and control has the effect of extending the residence status to companies incorporated outside, but centrally managed and controlled inside, Australia.⁴⁵ It was the classical test of residence of companies at common law. The test acknowledges that a company may not eat and sleep, but is based on the idea that it can keep house and do business.⁴⁶ The test looks behind the corporate veil to establish where a company is substantially rather than formally at home, where its real business is carried on,⁴⁷ to which territory it is really attached. This test and the next test reflect traditional corporate law, which regards the board of directors and the general meeting of shareholders as the two organs of a company which divide the control over the fate of a company between them. In the governing law context, the rationale for these tests was once stated to be that "a company which has its managing organs in France can be presumed to have French preoccupations and to revolve around French interests."⁴⁸ In the taxation context, the rationale for this test seems to be that a company is really at home where those who generate the taxable income are at home.

Given that the place of central management and control, which normally vests in the board of directors, has frequently been held to coincide with the place where the directors of the company meet,⁴⁹ the following concern has been expressed in relation to the impact of the Internet:

The development of video conferencing facilities and the relaxing in many countries of corporations law requirements for board meetings already facilitates board meeting being undertaken simultaneously in more than one jurisdiction. The Internet may soon be able to allow simultaneous (and relatively inexpensive) audio, video, and on-line communications between a number of users. This may make it easier, for example, for a company's place of effective management either existing in more than one location or not capable of being pinpointed to a specific location.⁵⁰

A slightly more confident commentator notes:

There is sufficient authority to indicate that it is likely that the courts will be able to modify the application of the central management and control test to the Internet environment, eg video conferences. However, applying a factual test to a course of business or trading on the Internet is likely to prove difficult, given the wide variety of business types and modes of operation that could arise on the Internet. The instantaneous and global facilities provided by the Internet are expected to allow residents to more easily influence the operations of their offshore

45 The requirement of "carrying on business in Australia" has been interpreted to be superfluous as far as the 'central management and control' test is concerned, following the decision in *Malayan Shipping Co Ltd v FCT* (1946) 3 AITR 258. At 261 William J noted that "if the business of the company consists of or includes its central management and control, the company is carrying on business in Australia." The same could be argued in respect of the third statutory test.

46 *De Beers Consolidated Mines Ltd v Howe* [1906] AC 455.

47 *Ibid.*

48 Note 34 *supra* at 174.

49 For example, *Koitaki Para Rubber Estates Ltd v FCT* (1940) 64 CLR 15; upheld by the Full Court of the High Court: (1941) 64 CLR 241.

50 OECD, *Electronic Commerce: The Challenges to Tax Authorities and Taxpayers*, November 1997, at <<http://jya.com/turku18.htm>> para 114.

subsidiaries (which would include tax haven entities). There is no clear guidance as to where such a business would be regarded as being really carried on.⁵¹

These concerns are at least partially unfounded. As to video conferences,⁵² the meeting place of the directors of a company is by no means conclusive evidence in relation to the location of the 'central management and control' of a company. Other factors, depending on the circumstances are location of the actual business operations,⁵³ residence of the managing director,⁵⁴ the place of incorporation and the location of the registered office.⁵⁵ In *North Australian Pastoral Co Ltd v FCT*⁵⁶ for example the taxpayer company was held to be resident in the Northern Territory although the directors (and the shareholders) met in Brisbane. In fact, the meeting place of the directors is normally simply a matter of convenience. In the above case five of the seven directors lived in Queensland. And in *Koitaki Para Rubber Estates Ltd v FCT*⁵⁷ the directors of a company registered as a foreign company in Papua of course met in Sydney because they all lived in Sydney. This makes the residence of the directors or the residence of the company's managing director a more rational choice for picking the place of central management and control. The directors meet where they live and not vice versa. The cases up to date do not give the residence of the directors any greater weight than their meeting place in establishing central management and control. However, given that the meeting place can be moved anywhere on the Internet via servers, the residence of the directors should assume greater relevance in the future. The company residence test would thus indirectly take advantage of the stability of the residence test for individuals. No doubt, courts will be sensitive to this development.

The situation is more complex, even if not new, where the directors who 'manage and control' a company live in different parts of the world. Traditionally courts have dealt with the problem of choosing amongst the differently located boards of directors by inquiring where the chief seat of management and the centre of trading of the company is located.⁵⁸ Who had responsibility over the more important tasks and who controlled the financial and administrative aspects of the business? The ease of communication via the Internet is likely to increase the incidence of global collaborative activities and of directors of merely one board

51 Australian Taxation Office, note 1 *supra* at 52, see also at 47.

52 Note *Magnacrete Ltd v Robert Douglas-Hill* (1988) 15 ACLR 325 in which the question of whether meetings of directors can be held without the directors being physically present at the same place, was considered. Perry J held that currently board meetings of directors may not be lawfully held by separate phone calls to directors, but may be held by a meeting set up by conference telephone.

53 *North Australian Pastoral Co Ltd v FCT* (1946) 71 CLR 623; cf *Koitaki Para Rubber Estates Ltd v FCT* (1941) 64 CLR 241.

54 *Malayan Shipping Co Ltd v FCT*, note 45 *supra*.

55 *Swedish Central Railways Co v Thompson* [1925] AC 495; *North Australian Pastoral Co Ltd v FCT* note 53 *supra*; cf *Egyptian Delta Land and Investment Co v Todd* [1929] AC 1.

56 (1946) 3 AITR 314. See also, *Waterloo Pastoral Co Ltd v Commissioner of Taxation* (1946) 72 CLR 262, where a company was held to be resident in the Northern Territory, although most of the meetings of the board of directors had been held in Sydney.

57 (1940) 2 AITR 167.

58 *De Beers Consolidated Mines Ltd v Howe* [1906] AC 455; affirmed in *New Zealand Shipping Co v Thew* (1922) 8 TC 208; *Bradbury v English Sewing Cotton Co Ltd* [1923] AC 744; *Koitaki Para Rubber Estates Ltd v FCT*, note 53 *supra*.

being spread across the globe. Yet, at least in the foreseeable future it seems likely that most of the new breed of multinational ventures will still be controlled by a core of directors concentrated in one jurisdiction, if for no other than cultural reasons. Therefore, as a matter of degree⁵⁹ and taking into account all circumstances, it should still be possible to say whether a company is more at home here or there. Although the financial and administrative aspects of a business are also likely to be centred in one country, to the extent to which the Internet allows these aspects to be moved offshore they should assume less significance in deciding residence in the future.

Even before the event of the Internet, cases have arisen where the question as to the whereabouts of the superior administration or control of the company's general affairs could not be answered. In those hard cases, where the central management and control is truly divided between two jurisdictions and the number of which will no doubt increase in the future, a company would seem to be resident in both jurisdictions,⁶⁰ and not as claimed in neither jurisdiction.⁶¹ Double tax treaties have attempted to relieve companies from double taxation by assigning priority of residence to one country, using as the determinative test the place of incorporation⁶² or the place of effective management⁶³ or a combination of both tests.⁶⁴ To the extent to which these tests mirror the residence tests for companies under Australian law they suffer from the same weaknesses. Implicitly, they also show that there are no easy answers to administering national revenue laws in a rapidly growing global economy. Nevertheless, since traditional tax havens are not normally parties to double tax agreements, companies managed and controlled both in Australia and one of the traditional tax havens are subject to the tax burden of residents in both countries.

The above discussion assumes that the directors are "the brain which controls the operation from which the profits and gains arise."⁶⁵ What about nominee or puppet directors of offshore operations and subsidiaries in tax havens which are remotely controlled via the Internet from Australia? A case in point is *Esquire Nominees Ltd v FCT*⁶⁶ about a company incorporated in the Norfolk Island. Although all its directors resided in the Norfolk Island and all meetings were held there, the company always acted in accordance with the directions of an Australian firm of accountants. Nevertheless, the High Court found that the company was not a resident of Australia, because on the evidence the directors of the company would not have acted on the instructions if they had considered them improper or

59 *North Australian Pastoral Co Ltd v FCT*, note 53 *supra*.

60 *Swedish Central Railway Co v Thompson* [1925] AC 495.

61 See text accompanying note 53 *supra*.

62 For example, Article 4(5) of the Agreement between Australia and the Philippines for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income.

63 For example, Article 4(3) of the Agreement between Australia and Switzerland for the Avoidance of Double Taxation with Respect to Income, Article 4(3) of the Agreement between Australia and Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion.

64 For example, Article 4(4) of the Convention between Australia and Canada for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income.

65 *Mitchell v Egyptian Hotels Ltd* [1915] AC 1022 at 1037.

66 (1972) 3 ATR 105.

inadvisable and thus they were not 'controlled', although strongly influenced, by the Australians.⁶⁷ This decision is dangerous, particularly in the digital era. It seems to open the doors for tax haven companies, with nominee directors and shareholders, which are controlled by Australian residents, but are non-residents anyway. The stronger reliance on substance in favour of form in the Australian decision in *Malayan Shipping Co Ltd v FCT*⁶⁸ and in the House of Lords decision in *Unit Construction Co v Bullock*⁶⁹ is preferable, especially in the Internet age. In the first case, the formal transactions performed by the nominee directors of a company in Singapore did not amount to 'central management and control'. In the latter case, three subsidiary companies in Kenya, which were, in fact but not formally, managed by the board of directors of the parent company in England were held to be residents of the United Kingdom.

In summary, provided that courts will adopt a substance approach, rather than the more formalistic view taken in *Esquire Nominees*, and are prepared to inquire into who really manages and controls (or strongly influences) a company, whether under name of director or not, the central management and control test will remain fairly effective in the Internet age. Its efficiency will be further protected if the courts generally attach greater weight to the residence of the directors rather than their meeting place, which can easily be shifted on the Internet. However, the number of hard cases, in which a company must be held to be resident in more than one country, will increase, even if not substantially in the foreseeable future.

C. Voting Power Controlled by Resident Shareholders

If a company is neither incorporated nor centrally managed and controlled in Australia, it is nevertheless an Australian resident for taxation purposes if its voting power is controlled by resident shareholders.⁷⁰ Again, this test looks behind the corporate veil; this time at the residence of the controlling shareholders who may be natural or artificial persons. The High Court of Australia has repeatedly interpreted 'control' to mean the actual use of control rather than the mere holding of more than 50 per cent of the voting rights at general meetings.⁷¹ This substance approach deters tax-planning practices where Australian residents acquire controlling voting power in an overseas company, but hold less than 50 per cent of the voting rights, to minimise the company's tax burden. This meaning given to control is also consistent with the underlying rationale of this third residence test which looks at the shareholders in their active role as the fortune-makers of the company through general meetings, rather than simply as passive investors.

This substance approach taken on the meaning of 'control' seems to contrast with the holding in *Mendes v Commissioner of Probate Duties (Vic)*⁷² in which the High Court held that a person who exercised de facto control of a company

67 *Ibid.*

68 note 45 *supra*.

69 [1959] 3 All ER 83.

70 For the equivalent test in the UK see the Finance Act 1988, s 66(1).

71 *Adelaide Motors Ltd v FCT* (1942) 2 AITR 341; *FCT v West Australian Tanners & Fellmongers Ltd* (1945) 3 AITR 243; *FCT v Commonwealth Aluminium Corp Ltd* (1980) 11 ATR 42.

72 (1967) 122 CLR 152.

(through the board of directors) without the legal capacity to control the company (at general meetings) did not 'control' the company. This has led commentators to conclude that 'control' involves both actual control and the legal capacity to control.⁷³ Yet, it should be noted that for income tax purpose a company which is controlled through a resident taxpayer via the board of directors (although not at the general meeting) is more likely than not a resident company under the second residence test already. Secondly, there is also one important exception to the de-facto-control position, which was affirmed in *Mendes* and described as follows:

a company A, which by virtue of its voting power in a general meeting of a company B controls that company, has a controlling interest in company C if company B holds the majority of votes in the general meeting of company C.⁷⁴

This exception which equates control with indirect control of a company through the general meeting may possibly become more relevant as the Internet opens up greater opportunities to invest in overseas companies or to incorporate businesses overseas with nominee shareholders. This exception seems to allow courts to inquire into the real source of power, which makes this third residence test for companies more resistant to tax planning/avoidance opportunities.

This final residence test has the virtue of certainty where the voting power at a general meeting is clearly controlled by a particular shareholder. But what about the situation where, for example, different shareholders hold controlling voting power on different matters capable of being dealt with at general meetings but no one holds absolute controlling voting power?⁷⁵ Or where Australian resident shareholders with more than 50 per cent of voting rights may exercise their voting power but do not exercise it in a group,⁷⁶ or do not always exercise it in a group, but take at times different stances? These situations fall outside this residence test although the capital and wit of Australian residents may significantly help to generate the profits of the company in question. While these gaps theoretically have potential to be exploited, particular as international share trading over the Internet is promised a great future,⁷⁷ strangely no one seems to be too concerned about this test. The reason is that this test is of minimal significance, by virtue of Australia's double tax agreements, which normally rely on the incorporation test and/or the effective management test to determine sole residence. Thus, companies resident in Australia pursuant to the third test only, would not be deemed resident in Australia pursuant to these agreements, which prevail.⁷⁸ Of course, this does not apply to tax havens. Yet, it appears that most companies incorporated in tax havens whose voting power is controlled by resident shareholders would also be

73 G Lehmann and C Coleman, *Taxation Law in Australia*, Butterworths (3rd ed, 1994) p 981.

74 *Ibid*, p 162.

75 This was the case in *Mendes v Commissioner of Probate Duties (Vic)*, note 72 *supra*.

76 G Lehmann and C Coleman, note 73 *supra*.

77 The Internet "will allow companies to establish a public market in their own shares and execute transfers electronically without using the ASX or even brokers." *The Australian*, 6 July 1998. Not only will the Internet greatly impact on the trading of securities, but modern computer technology will allow general meetings to be held at two or more venues, and thus allow for greater participation of shareholders at general meetings. R Baxt, K Fletcher and S Fridman, *Afterman and Baxt's Cases and Materials on Corporations and Associations*, Butterworths (7th ed, 1996) p 480.

78 *International Tax Agreements Act 1953* (Cth), s 4(2).

centrally managed and controlled in Australia and thus already be a resident taxpayer under the second test.

In summary, the third statutory test to determine company residence seems fairly resistant to legal abuse in the Internet age, for example through nominee shareholders in an overseas company. Generally, it rests on the substantive search for the people or entities who really control a company through the general meeting. Its weaknesses are not fatal, particularly given the test's rather small significance in determining residence which in itself casts doubts on its value.

IV. CONCLUSION

The above survey of the residence tests of individuals and companies under Australian law is intended to show two things. First, the real potential of the Internet to artificially move residence is clearly dependent on the reliance on a formal rather than substantial nexus between the individual or entity and the territory in defining residence. While the residence test for individuals is an example for successfully exploiting the real nexus the individual has with the territory, the incorporation test for companies shows how a mere formal link with the territory maybe highly vulnerable to manipulation in Internet age. One way to deal with this problem is to turn the formal nexus into a substantial nexus. Like most individuals would not be prepared to leave Australia indefinitely just to gain a tax advantage because of social ties and lifestyle, there may be ways to make Australia attractive to businesses as a place of incorporation and to create ties which the company does not want to cut. Of course, the substantial nexus is precisely that on which the central management and control test relies, namely the real ties directors of a company have with Australia. Provided a small adjustment is made by according more weight in deciding residence to the place of residence of the majority of the directors or de facto controllers rather than their meeting place, the major tax planning opportunity the incorporation test creates in the Internet era will be removed.

The second conclusion of this paper concerns the long term prospects of the residence tests within a smaller world economy and is more worrying. While the Internet per se does not create substantial opportunities to artificially move residence of an essentially local business, the opportunities for global collaborative ventures created by the Internet will make the issue of 'residence' of a company or business more often difficult to decide, even if a real economic substance approach is adopted. An extreme example may be a virtual company, incorporated in a tax haven, whose directors have equal shareholding and who all live in different parts of the world and meet in cyberspace. There are no magic solutions to deal with such a scenario, as it exhibits the basic conflict between nationally based revenue laws and international business. One way to adjust to the new phenomena, within the traditional national framework, may be to reformulate the residence test for companies. For example the second and third test rather than being alternatives might prove more useful and easy to administer as expressly stated criteria to determine residence pursuant to a broadly based control test, apart from the

incorporation test. Other expressly stated criteria may be the place of the registered office, the place of incorporation and the place where the shareholders' meetings are held.⁷⁹ Even in less than clear-cut cases, it is likely that, taking into account all circumstances, the balance will tip in favour of one country. Given that the tie-breaker provisions in the double tax treaties prevail, this broader approach should also be incorporated into the international agreements. This is a half-hearted solution and from an administrative point of view not likely to be very efficient. To tackle the problem in the long term it may be necessary for revenue authorities to resort to more radical cures. The obvious one which comes to mind is that revenue authorities must open up to the international sphere and cooperate much more closely, just like the businesses they are chasing.

79 L Edwards and C Waelde, *Law and The Internet*, Hart Publishing (1997) p 171.